

Internal Revenue Service
memorandum

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to: Candy Davis-Alicea IN:C:TP:PR

from:  George M. Sellinger, Chief, Branch 1
Office of Associate Chief Counsel (International)

subject: Source of Department of Agriculture Crop Damage Compensation Payments

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This is in response to your inquiry of May 3, 1991, with regard to whether Department of Agriculture crop damage compensation payments are U.S. source income. This memo concludes that the payments are not U.S. source income and that they are not taxable to Puerto Rican recipients under section 933 of the Code.

Facts

In 1989, Hurricane Hugo devastated much of Puerto Rico, and President Bush declared it a disaster area. Victims of the hurricane were authorized to apply for aid under the Disaster Relief Act of 1989, Pub. L. No. 101-82, 103 Stat. 3359 (1989). Sections 101-05 of the Act provided that payments would be made directly to farmers for crop damages incurred as a result of the hurricane. The payments were equal to 65% of the established price of the crop for losses of at least 35% of normal production. No payments were made for losses of less than 35%-50% of normal production (the payment threshold varied depending on the type of crop destroyed). No additional funds were provided for losses suffered as a result of reduction in crop quality. Moreover, relief payments were reduced by the value of any replacement crops planted on acreage for which disaster relief had been requested. The total amount of benefits received by an individual in 1989 could not exceed \$100,000. The Agricultural Stabilization and Conservation Service distributed the aid in the form of Commodity Credit

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Corporation certificates, which were exchanged by the farmers for cash.¹

The Department of Agriculture characterized payments made under the Act as outright grants of aid, neither loans nor amounts due under crop insurance programs. Your office would like to know whether the payments are taxable to Puerto Rican recipients of the aid.

Law and Analysis

I.R.C. Section 876(a) provides that bona fide residents of Puerto Rico are subject to the U.S. income tax imposed by I.R.C. Section 1. However, I.R.C. Section 933 notes that income derived from sources within Puerto Rico by an individual who is a bona fide resident of Puerto Rico are excluded from gross income and exempt from taxation.

Payments made under the Disaster Assistance Act of 1989 are considered income and are subject to the income tax imposed by section 1. In Boboquivari Cattle Company v. Commissioner,² it was established that agricultural aid payments made by the government are taxable, absent a clear indication that Congress did not intend to tax the payments. The Disaster Relief Act of 1989 did not specify that payments made under the Act were to be tax exempt.³ Therefore, unless the payments made to farmers in Puerto Rico are considered Puerto Rico source income, the farmers must include those payments in their U.S. gross income.

Sections 861 and 862 of the Code specify the sources (within or without the United States) of particular items of income. The sections do not provide a rule for determining the source of Department of Agriculture aid. I.R.C. Section 863(a) states that the source of items of income, other than items specified in 861 and 862, will be determined under regulations prescribed by the Secretary. Unfortunately, there are no regulations addressing the source of this type of income. One must therefore look to analogous types of income

¹Letter from Angelena Bracht, Controller, U.S. Department of Agriculture to Douglas Fehey, Attorney, Income Tax and Accounting, December 19, 1989.

²47 B.T.A. 129 (1942), aff'd, 135 F. 2d 114 (9th Cir. 1943).

³Notice 89-55, 1989-1 C.B. 696, takes the position that payments made under a similar act, the Disaster Assistance Act of 1988, are taxable under section 1.

to determine the source of the disaster relief payments.

On the one hand, the agricultural aid could be analogized to other grants of aid given to foreign beneficiaries, such as scholarships given to foreign students. Rev. Rul. 89-67,⁴ provides that "[a]bsent a significant economic nexus with the place where the study and research and puzzle solving activities are performed, it is more appropriate to source these payments where the principal economic nexus exists, namely, at the residence of the payor." The rationale for this rule is that the grant is likened to investment income, sourced where the principal is invested. Since Puerto Rico farmers do not perform any services for the U.S. government in consideration for disaster relief assistance, one may argue that the principal economic nexus of the aid payments is the residence of the payor, and that the source of the payments should be the United States.

On the other hand, the aid could be analogized to compensation or insurance paid for property loss. In Rev. Rul. 76-154, 1976-1 C.B. 191, a U.S. person received compensation from a foreign country because the taxpayer's assets in the country had been expropriated. The ruling cited Rev. Rul. 73-252⁵ (which, in turn, cites a number of older cases) for the proposition that "the main factor in determining the source of income of payments received is whether the location of the property to which the payment related or the situs of the activities that resulted in its being made was in the United States or abroad." The ruling concluded that since the expropriated property was located abroad, and since the act giving rise to the compensation occurred abroad, the compensation was foreign source income.⁶

Notwithstanding the fact that the authority on which Rev. Rul. 76-154 rests is somewhat outdated, the ruling's reasoning is sound, and we believe that it should be applied in determining the source of the disaster relief payments here. The provisions of the Disaster Relief Act of 1989 are included in 7 U.S. Code § 1421, which provides comprehensive rules for supporting the prices of various commodities. Payments under the Act are compensatory in nature: no payments are made for losses of less than 35% of normal production, or for losses for which relief has been provided from other sources. Since

⁴1989-1 C.B. 233.

⁵1973-1 C.B. 337.

⁶1976-1 C.B. at 192.

the act that resulted in the payments being made was Hurricane Hugo's devastation of Puerto Rico, and since the property to which the payments related was located in Puerto Rico, the assistance payments should be considered Puerto Rico source income.

In addition, it may be noted that the Disaster Relief Act payments were intended to replace a stream of income that ordinarily would be considered income from sources within Puerto Rico. If the crops had been grown and sold in Puerto Rico, as anticipated, the income would not be considered U.S. source income.⁷

The characterization of the relief payments as compensatory amounts is supported by section 451(d) of the Code. Section 451(d) and Treas. Reg. § 1.451-6T provide that a taxpayer receiving the proceeds of crop insurance may defer reporting the proceeds for a year. Payments made under the Disaster Assistance Act of 1989 are considered insurance proceeds for this purpose. As noted above, the nexus of these payments was Puerto Rico, and they should be considered foreign source income.

Conclusion

Payments made to farmers in Puerto Rico under the Disaster Relief Act of 1989 should be considered income from sources in Puerto Rico.

⁷See I.R.C. Sections 865(b), 863(b)(3).